Research

FTSE Russell

Harnessing the long-term potential of dividend growth

A large body of research has found that the stocks of companies that can consistently grow their dividends over time have been attractive sources of income and long-term wealth creation. Dividend growth stocks also have a strong record of long-term outperformance, owing in large part to their resilience in market downturns. This has been true despite periodic bouts of underperformance, which typically occur when risk appetite is high and faster growing, riskier stocks are in favor. Harnessing this potential requires a disciplined approach and a long-term investment view.

In this paper, we explore the key characteristics and return patterns that have differentiated dividend growth strategies over time.

The dividend growth proposition

- **Long history of outperformance.** As research shows, persistent dividend growers have strongly outpaced broad market benchmarks historically, with significantly less volatility.
- **The quality connection**. Steady dividend growth often goes hand in hand with stable earnings streams, good corporate stewardship and resilient business models—desirable attributes with enduring investment value, particularly for investors with long-term horizons.
- **Downside defenses.** History shows that dividend growth stocks possess relatively strong defensive qualities, which tend to mostly come to the fore during periods of acute market stress.

Reliable dividend growers are popular among investors for their stable cash flows, healthy balance sheets and durable business models

Why invest in dividend growth?

Interest in dividend-paying stocks has burgeoned over the past few years as the post-crisis era of ultra-low interest rates spurred an intense investor hunt for yield. More recently, attention has focused on the need to ensure the long-term viability of dividends being paid, rather than simply on maximizing the current dividend yield. This has prompted the rise of index-based investment products such as ETFs and mutual funds targeting dividend growth.

Dividend-growth investing has a history of providing steady income streams and outperformance over long time horizons

Dividend growth strategies have little in common with traditional growth strategies, which typically focus on companies that reinvest excess cash back into pro-growth initiatives or acquisitions. Dividend growth investing strategies also differ from those that target high-yielding dividend payers—a common value investing approach that considers firms showing a greater-than-average commitment to returning cash to shareholders. Dividend-growth investing has

amassed an impressive history of long-term income and wealth generation. FTSE Russell research of US stocks between 1987−2014 found that annualized returns of firms that regularly raised their dividend payouts over a period of ten years or more averaged 13.9%, or 3.8 percentage points higher than dividend payers that did not increase them.[1] Compounded over time, these excess returns can make a big difference in cumulative portfolio values.

This outperformance can be largely explained by two factors: low volatility and high quality. Firms that pay increasing dividends over time are often viewed as having greater confidence in future earnings, healthy balance sheets and relatively conservative, shareholder-friendly capital management policies. Increasing dividends may be seen as an indicator of the long-term potential for higher returns, lower stock-price volatility and/or smaller downside risk.

The FTSE Dividend Growth Indexes: A US small-cap focus

To meet growing investor interest, FTSE Russell launched the FTSE Dividend Growth Index Series in late 2014. This series specifically targets US companies that have successfully raised their dividend payments over ten years or more[2], and that meet liquidity criteria to ensure that the resulting indexes contain suitably tradable constituent baskets. Rather than weighting by dividend or market capitalization, FTSE Russell equal-weights constituents to ensure stock-level diversification and then, to prevent further industry concentration, does not allow any individual industry weight to exceed 30% of the index. To maintain appropriate weightings, index constituents are rebalanced to equal weight quarterly.

FTSE Russell equal-weights the constituents of the FTSE Dividend Growth Indexes to ensure stock-level diversification, a key differentiator

In this paper, we cast the spotlight on the characteristics and long-term return patterns of the small-cap version of this series (Exhibit1), the Russell 2000 Dividend Growth Index (R2000 DG). Roughly 42% of the Russell 2000 (or 843 stocks) pay dividends, versus 70% (696 stocks) in the large-cap Russell 1000. By our analysis, dividends have accounted for approximately 10%-20% of R2000 DG total returns, double the 5%-10% for the Russell 2000.

Exhibit 1: Index Characteristics (August 2018)

	Russell 2000® Dividend Growth Index	Russell 2000® Index
Market Cap ($ Wgt. Avg in USD Bil.)	1.3	2.7
Number of Holdings	61	2,000
Dividend Yield: Five Year Avg. (%)	2.3	1.2
Dividend Payout Ratio: Five-Year Avg. (%)	45.1	16.7
Price/Trailing Earnings (×)	21.4	19.1
Price/Sales (×)	1.5	1.3
Price/Book (×)	2.3	2.3
Price/Cash Flow (×)	11.4	11
Return on Equity (Five-Year Average)(%)	11.3	5.8

Source: FTSE Russell and FactSet. Data as of August 31, 2018. Past performance is no guarantee of future results. Please see the end for important legal disclosures.

[1] ProShares, Ned Davis Research and FTSE Russell constituent analysis, February 2, 1987 to December 31, 2014.

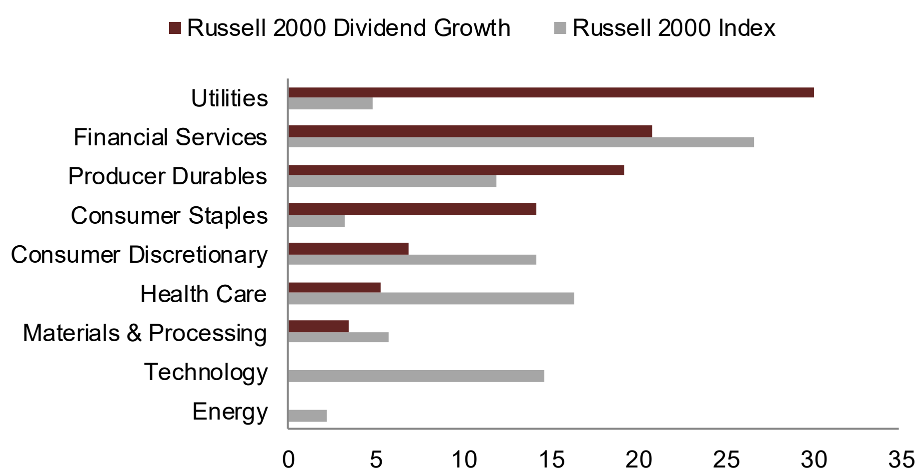
[2] In certain rare circumstances, companies with less than ten years of dividend growth could be included in the indexes. These are explained in the index construction and methodology document available from ftserussell.com.

The more selective R2000 DG's average constituent market capitalization is smaller than that of its parent, reflecting its tilt away from larger-cap companies. As expected, dividend yield and dividend payouts are significantly higher. Valuations are lower based on trailing earnings and cash flows, consistent with the bias toward value. Although annual earnings growth has tended to be slower, R2000 DG's return on equity is higher than its parent's, in line with its greater bias on stable earners and companies with strong balance sheets. Our analysis of style characteristics and returns of the R2000 DG index shows a significant tilt toward value, a consequence of its emphasis on dividend growth and its impact on sector allocation.

The dividend growth index is more concentrated, offers higher dividend yields and pay outs and tends to have more stable earnings streams than its parent index

Because of its equal weighting and focus, the R2000 DG differs materially from its parent in terms of sector and style exposures. It is significantly overweight utilities, producer durables and consumer staples versus its small-cap parent, and most underweight technology and energy (Exhibit 2), industries in which the smallest firms rarely pay dividends.

Exhibit 2: Comparative Sector Weights (%)



Source: FTSE Russell and Refinitiv as of August 31, 2018. Past performance is no guarantee of future results. Please see the end for important legal disclosures.

Smoother return pattern drives long-term outperformance

Over the 10-year period ended July 31, 2018, the R2000 DG index would have achieved greater annualized returns with less volatility than its parent index. The

R2000 DG has generated much stronger risk-adjusted returns over the past 20 years than its parent

Exhibit 3: Performance Statistics—Russell 2000 Dividend Growth Index vs. Russell 2000

	Annualized Return	Annualized Volatility	Beta	Excess Return	Return/Risk Ratio
R2000 DG	12.4%	15.1%	0.63	3.6	0.83
Russell 2000	8.8	19.4	1.00	—	0.46

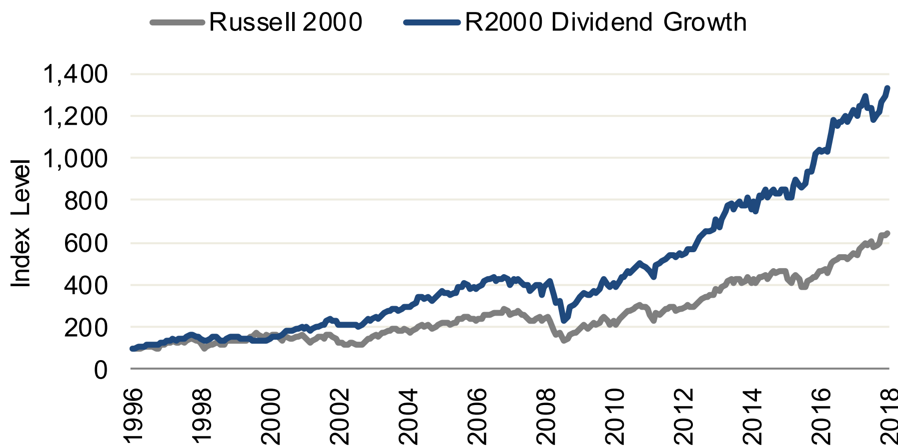
Source: FTSE Russell and Refinitiv. Data from June 30, 1998, through July 31, 2018. Past performance is no guarantee of future results. Please see the end for important legal disclosures.

reduction in risk from 19.4% to 15.1%, combined with the 3.6 percentage-point increase in return, translated into a risk-adjusted return of 0.83, almost double the 0.46 ratio for the Russell 2000 (Exhibit 3, previous page). It also showed a beta well below that of its small-cap parent index, indicative of its lower risk credentials.

Exhibit 4 shows that the R2000 DG has significantly outperformed the broader small-cap parent index on a cumulative basis for the 12 years ended July 2018, resulting mainly from its lower drawdowns during market slumps and subsequent participation in market rallies.

Steadier return patterns helped the R2000 DG deliver superior long-term performance versus the broader small-cap index

Exhibit 4: Cumulative Total Returns − Russell 2000 Dividend Growth Index vs. Russell 2000 Index (% USD, Rebased)

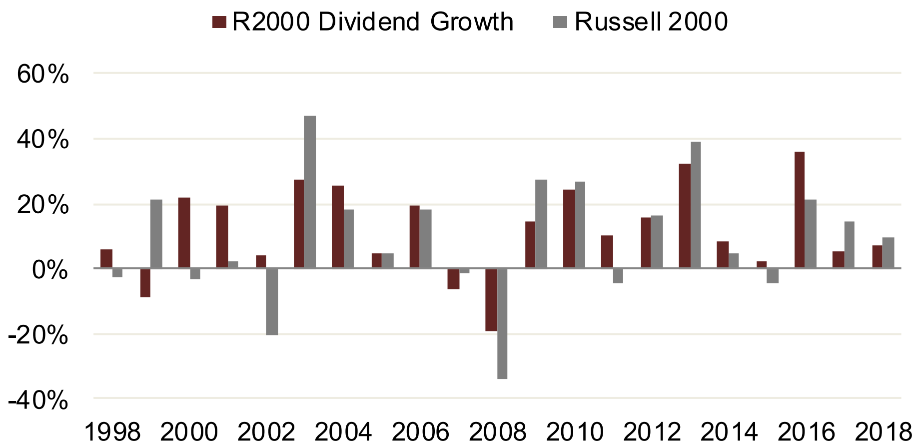


Source: FTSE Russell and Refinitiv. Data from July 31, 1996, through July 31, 2018. Past performance is no guarantee of future results. Please see the end for important legal disclosures.

The R2000 DG's defensive credentials stand out most during major small-cap market routs

As Exhibit 5 illustrates, the index's focus on dividend growth and higher quality would have produced significant downside protection during the small-cap market downturns of 2002, 2008 and 2011. What's also apparent is that while the R2000 DG posted strong gains during most market rallies since 1998, its parent

Exhibit 5: Calendar-Year Performance (YoY % Change)



Source: FTSE Russell and Refinitiv. Data from July 31, 1998 through July 31, 2018. Past performance is no guarantee of future results. Please see the end for important legal disclosures.

index generally did better. For the past two years, for example, the index lagged the broader small-cap index, attributable to the significant shift in investor preferences amid the Fed's steady rate-hiking regime and a buoyant US economy. As interest rates have risen and risk appetites improved, investors have favored faster-growing beneficiaries of a strengthening business cycle.

The most notable underperformance occurred at the height of the Internet bubble, reflecting the small-cap R2000 DG's lack of exposure to mostly non-dividend-paying (and, in some cases, money-losing) technology companies driving the market rally at that time. During the subsequent market collapse, however, R2000 DG more than made up the lost ground. In another period of underperformance, the R2000 DG fell more than its parent index in 2007, attributable to its heavier weight in hard-hit financials that year, though it held up better in the 2008 market crash.

The attribution analysis in Exhibit 6 below details the contributions from stock and sector selection to the R2000 DG's relative performance since 2014. The key point from this analysis it that stock selection has historically generated the majority of outperformance. While the large overweight to the utilities sector was a major source of the dividend growth index's outperformance versus its parent index, the aggregate sector allocation effects were a relatively small driver. In fact, the effects of stock selection (6.2%) added more than twice as much to R2000 DG relative returns as did sector allocation (2.7%).

Upside/downside market capture

Upside and downside capture ratios are another way to evaluate how an index behaves under various market conditions. It is calculated as the average index return divided by the average benchmark return in both rising and declining

Exhibit 6: Attribution Analysis—Russell 2000 Dividend Growth vs Russell 2000 Since 2014 (% USD)

			R2000 Dividend Growth		Russell 2000		Attribution Analysis		
	R2000 DG Average Weight	Russell 2000 Average Weight	Total Return	Contribution to Return	Total Return	Contribution to Return	Allocation Effect	Stock Selection Effect	Total Effect
Basic Materials	5.37	3.99	19.77	0.90	26.58	1.42	-0.28	-0.94	-1.22
Consumer Goods	11.25	7.15	66.49	8.02	40.31	3.20	-0.28	3.73	3.46
Consumer Services	7.70	11.63	66.64	6.10	38.86	4.20	0.44	3.39	3.84
Financials	22.43	25.32	62.94	13.09	62.33	16.55	-0.09	0.08	0.00
Health Care	6.09	13.55	36.74	3.02	93.58	9.93	-2.73	-2.05	-4.78
Industrials	16.42	17.42	51.37	5.68	48.02	8.86	-0.48	-0.59	-1.07
Oil & Gas	0.77	3.52	-84.73	-4.11	-53.51	-4.28	3.90	-2.40	1.50
Technology	0.00	13.04	0.00	0.00	85.61	10.51	-4.07	0.00	-4.07
Telecommunications	1.46	0.71	21.71	1.05	37.24	0.31	-0.03	0.35	0.32
Utilities	28.51	3.31	103.45	27.82	78.53	2.97	5.43	4.59	10.02
[Unassigned]	0.00	0.37	0.00	0.00	-85.49	-0.94	0.82	0.00	0.82
Total	**100.00**	**100.00**	**61.57**	**61.57**	**52.75**	**52.75**	**2.65**	**6.17**	**8.82**

Source: FTSE Russell and Refinitiv. Data from December 31, 2013 through July 31, 2018. Past performance is no guarantee of future results. Please see the end for important legal disclosures.

markets. An upside capture ratio above 100% means that the index outperformed the market (the Russell 2000 in this case) during periods of positive benchmark returns, and a ratio below 100% means the index underperformed market. Conversely, a downside capture ratio of less than 100% indicates that the index has lost less than its benchmark when the benchmark has been in the red and vice versa.

By our analysis, the R2000 DG's upside capture ratio averaged 75% since 1998, and its downside capture ratio averaged 52%. By capturing far more upside in rallies than it has lost in downturns, the dividend growth index ended the 20-year period with significantly higher cumulative capital balance than its parent index. Once again, this performance demonstrates the benefits of lower risk drag on long-term capital accumulation.

The R2000 DG captured far more upside in rallies than it lost in downturns, helping it outperform over the full market cycle

Correlations

Over the full period of the calculated index back-history, the two-year rolling correlation between the R2000 DG and the Russell 2000 was 81.0% (Exhibit 7). However, prominent breaks in correlations between the dividend growth index and its broad-universe index emerged during significant market drawdowns. As noted earlier, comparative performance over these periods—the years 2000, 2001 and 2008, as shown in Exhibit 6—demonstrates the potential for the R2000 DG to provide downside protection.

Correlations between the R2000 DG and its parent plunged in the aftermath of the dotcom bubble collapse, owing mostly to its lack of technology exposure

The large drop in correlations between the two indexes from 2000 through early 2001 coincided with the run-up and aftermath of the Internet bubble and the subsequent crash.

Our analysis indicates that the primary reason for this divergence was the negligible exposures of the R2000 DG to technology, energy and health care stocks relative to the broader small-cap index. At that time, many of these companies were in the early stages of their lifecycles and, thus, less likely to be dividend issuers. During that period, much of the Russell 2000 performance was being driven by these companies, so their absence from the R2000 DG resulted in the unusually low correlations observed.

Exhibit 7: Historical Two-Year-Rolling Correlations − Russell 2000 Dividend Growth vs. Russell 2000 Indexes

Source: FTSE Russell and Refinitiv. Date from June 30, 1998, through July 31, 2018. Past performance is no guarantee of future results. Please see the end for important legal disclosures.

Summary

With bond yields mired near historic lows for most of the post-crisis era, dividend investing has enjoyed a dramatic resurgence in interest over the past several years. Although dividends have long been a major boon for portfolio total returns, companies that can deliver dependable dividend growth - rather than the highest yields - have taken center stage as a core part of portfolio management strategies emphasizing capital preservation and income generation.

Focusing on reliable dividend growth is commonly viewed as a core part of capital-preservation and income-generating strategies

Conditions are supportive. A strong US economy and the passage of a large corporate tax cut last December have helped companies grow earnings and free cash flow, resulting in record levels of cash on corporate balance sheets. Part of the tax overhaul also incentivized US multinationals to repatriate profits booked overseas, which totalled roughly $1 trillion (in liquid assets) by year-end 2017, according to the US Federal Reserve. Government data shows that US multinationals brought back $465 billion of overseas earnings in the first six months of 2018, or more than all of those recorded in 2015, 2016 and 2017 combined.

Though stock buybacks have accounted for the lion's share of the resulting surge in shareholder cash-return activity (In a September report, Goldman Sachs estimated that buyback authorizations were on track for a 46% increase this year), record earnings and the flood of repatriated cash have also helped bolster dividend payments. S&P Dow Jones data indicate that US companies has increased dividend payments by 7.2% through August this year, up from 2.3% in 2017, with the potential for double-digit gains for the full year. That would put US firms on the way to the seventh consecutive year of record dividend payments.

Reliable dividend growers are typically companies with solid quality credentials, such as stable earnings, strong balance sheets and conservative capital management policies. Over time, the R2000 DG Index has performed as would be expected: typically losing less in market crashes while still participating in rallies, culminating in significant outperformance over full market cycles—and with less volatility. Tapping the full benefits of the dividend growth potential requires a disciplined approach and a long-term investment horizon.

Appendix

Construction methodology

Each Dividend Growth index is a specially selected subset of a corresponding parent Russell market-cap-weighted index that is screened via a rules-based methodology to ensure replicability (liquidity and tradability screens), dividend growth and diversification.

FTSE US Dividend Growth Index Series	Russell US Index (parent index)
Russell 1000® Dividend Growth Index	Russell 1000® Index
Russell 2000® Dividend Growth index	Russell 2000® Index
Russell 3000® Dividend Growth Index	Russell 3000® Index

Liquidity and tradability screening

For each of the three US Dividend Growth indexes, the same liquidity and tradability screen is used. This is created using the Russell 2000 Index constituents, which are ranked in order of 20-day average daily dollar traded volume (ADDTV). The ADDTV of the company at the 20th percentile is noted, and this ADDTV threshold, computed from the Russell 2000 constituents, is applied to the constituents within each of the three parent indexes. For each universe, therefore, constituents that are at or above that threshold comprise the set of securities eligible for further screening.

Dividend growth criteria

The remaining securities are assessed for dividend growth over time. Eligible securities must have paid increasing per-share regular cash dividends for ten or more consecutive years. If dividend data is missing for any individual quarter, quarterly DPS must have increased at least once in each of the last ten years, and there must not have been any decreases in quarterly DPS.

Diversification: Constituent selection and weighting process

FTSE Russell then assesses the number of remaining eligible stocks in each universe. Where there are fewer than 40, constituents with nine years of increasing dividends are added to the remaining list in descending order of dividend yield, until the total number of remaining constituents is 40. If there are still fewer than 40, constituents with eight years of increasing dividends are added. If after this step there are still fewer than 40 constituents, no further additions are made. The remaining stocks are equal-weighted.

Where any sector represents 30% or more of the index, constituents are removed from that sector in ascending order of dividend yield until the sector represents less than 30%. If the total number of remaining constituents is fewer than 40, constituents with nine years of increasing dividends are added to sectors with weights below 30%, in descending order of dividend yield, until there are 40 constituents. If there are still fewer than 40, the process is repeated, using constituents with eight years of increasing dividends. If after this step there still are fewer than 40 constituents, the process is not continued further.

Reconstitution and quarterly review

To maintain its relevance and representativeness over time, each index in the FTSE Dividend Growth Index Series is completely reconstituted annually in June, in parallel with the reconstitution of the Russell US Indexes. To reduce the deviation from constituent equal weights resulting from market movements, the indexes are rebalanced to equal weight each quarter. The quarterly rebalance will be implemented after the close of business day on the third Friday in March, September and December.

Footnotes

[3]ADDTV is defined as the accumulated trading value over the past twenty trading days, divided by twenty. For additional information on ADDTV, refer to the Russell Global Index construction and methodology document available at ftserussell.com.

[4]Reconstitution of the Russell US Indexes and the FTSE Dividend Growth Index Series is effective the last Friday in June, with the following exceptions: If the last Friday in June is the 29th or 30th, reconstitution will occur on the Friday prior. A full calendar for reconstitution is made available each spring on ftserussell.com. More information on the reconstitution of the Russell Global Index is included within the Russell US Indexes Construction and Methodology document, available at ftserussell.com

The FTSE Dividend Growth Indexes started “live” calculation on November 25th 2014. Index values prior to this are back-calculated. Historical returns prior to the live production date are calculated using the same methodology; however, application to the performance calculation may vary due to data sources, corporate actions and the availability of historical data with respect to certain securities.

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